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No. 254

In the Supreme Court of the United States

OCTOBER TERM, 1942

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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OPINIONS BELOW

The opinions of the Court of Appeals (R. 139–155)[1] are reported in 128 F. (2d) 303. The Findings and Opinion of the Commission (R. 63–79, 115–132) are reported in 8 S. E. C. 893. The Sup-

[1] References to printed portions of the record before the Commission and to the record in the court below are designated by the symbol "R." References to the Commission's transcript certified to the court below, which by stipulation filed in this Court may be referred to in the briefs and upon the argument, are designated by the symbol "Tr."

plemental Findings and Opinion of the Commission (R. 104–113) and the Report of the Commission on a Plan of Reorganization (R. 97–104) are reported in S. E. C. Holding Company Act Release No. 3023.

JURISDICTION

The judgment of the Court of Appeals was entered April 27, 1942 (R. 155). The petition for a writ of certiorari was filed July 25, 1942, and was granted October 12, 1942 (R. 159). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925, made applicable by Section 24 (a) of the Public Utility Holding Company Act of 1935.

QUESTION PRESENTED

Directors and officers of a registered holding company purchased preferred stock of the company during a period in which the management of the company, which they controlled, proposed to the Securities and Exchange Commission successive plans of reorganization pursuant to the Public Utility Holding Company Act of 1935. The Commission declined to approve a plan on the ground that the plan permitted the preferred stock so purchased to participate in the reorganization on a parity with all other preferred stock. Thereafter, the plan was amended to provide that the preferred stock so purchased, unlike the other

preferred stock, would not be converted into stock of the reorganized company, but might be surrendered to the reorganized company at cost plus interest. Over the objection of the directors and officers involved, the Commission approved the plan as amended.

The question is whether the Court of Appeals erred in reversing the Commission's order based upon the Commission's finding that it would be detrimental to the interests of investors and unfair and inequitable within the meaning of the Act to allow the preferred stock so purchased to participate in the reorganization on a parity with all other preferred stock..

STATUTE INVOLVED

The pertinent provisions of the Public Utility Holding Company Act of 1935, c. 687, 49 Stat. 803, are set forth in the Appendix, *infra*, pp. 47–55.

SPECIFICATION OF ERRORS

The court below erred:

(1) In failing to affirm the Commission's holding that the respondents were subject to fiduciary obligations which precluded them from profiting through trading in the securities of their corporation during the period of reorganization.

(2) In failing to affirm the Commission's determination that a plan of reorganization under which preferred stock so acquired by respondents would participate on a parity with all other pre-

ferred stock was detrimental to the interests of investors and unfair and inequitable within the meaning of the Act.

(3) In reversing the Commission's order approving a plan which allowed no participation to stock acquired by respondents during the period of reorganization, and required the surrender of such stock at cost plus four percent interest.

STATEMENT

Federal Water Service Corporation (hereinafter called Federal) was a registered holding company controlling subsidiaries which operated water, gas, electric and other properties in thirteen states and in one foreign country (Tr. 457-458). Federal registered as a holding company under the Public Utility Holding Company Act of 1935 on November 8, 1937 (R. 2).

Federal's capital structure.—At the time of its registration, Federal's capital structure (based upon a statement dated September 30, 1937) was, in summary, as follows (Tr. 41):

5½ Gold Debentures, due 1954		$6,898,500.00
Preferred stock, 159,269 shares	*$15,189,639.75	
Class A stock, 568,775 shares	*13,998,733.50	
Class B stock, 542,450 shares	*2,500,000.00	
Total capital stock		31,356,373.25

*All without par value; shown at stated values.

The preferred shares had dividend and liquidation preferences over the Class A and Class B shares and the Class A shares had comparable

preferences over the Class B shares (Tr. 4–5). The Class B shares had the entire voting power except in respect of the creation of liens, the issuance of prior preferred shares, and the election of three of the seven directors (Tr. 5, 17–19).

From 1932 through 1935 the company's income had been less than its interest charges and expenses (Tr. 47, 49–51).[2] Annual dividend requirements on the preferred stock aggregated about $1,000,000, and on the Class A, approximately $1,137,000 (Tr. 4–5). No dividends had been paid on any class of stock since 1931 (Tr. 615). At November 7, 1937, dividend arrearages on the preferred stock amounted to nearly $6,000,000, while arrearages on the Class A stock totalled approximately $7,000,000 (Tr. 4–5, 41).

As of September 30, 1937, Federal's books disclosed a deficit in its surplus account in an amount equal to approximately half the stated value of its Class B stock (Tr. 9, 41–43). In addition, financial statements filed with the Commission showed the fair value of Federal's investments to be at least[3] $5,000,000 less than the $35,477,170

[2] These figures are on a corporate basis and do not take into account undistributed income in the hands of subsidiaries (Tr. 47, 49–51; R. 101).

[3] A then-current appraisal prepared by appraisers selected by Federal indicated that the fair value of Federal's investments was fully $10,000,000 below carrying value, of which sum only $5,000,000 was reflected in the financial statements (Tr. 41–43; 92–95).

carrying value (Tr. 41–43). If this diminution of value had been fully reflected on the corporate books, there would have resulted a deficit in excess of the stated capital applicable to the Class B stock (Tr. 9, 41–43).

The respondents' plans.—Even before Federal registered under the Act, its management recognized the need for reorganization (Tr. 10–11; R. 118). As the Commission found (R. 117), there were two incentives to reorganization. The primary incentive lay in Federal's deficits, for the Delaware law prohibited payment of dividends on any class of stock as long as the capital represented by stock having a preference on distribution of assets was impaired (R. 117).[4] Another incentive was found to exist in the fact that Federal's capital structure was plainly such as to confront Federal with the prospect of compulsory simplification under Section 11 (b) (2) of the Public Utility Holding Company Act unless it could succeed in thoroughly revamping its structure by some other permissible method (R. 118).

Accordingly, as soon as Federal registered on November 8, 1937, it immediately voluntarily submitted a plan of readjustment to the Commission in the form of a proposal, described more fully hereafter, to exercise a "privilege or right to alter the priorities, preferences, voting power, or other rights of the holders" of its outstanding classes

[4] Del. Rev. Code (1935) § 2066.

of stock, within the meaning of Section 6 (a) (2) of the Act (Tr. 1–15). After the initial plan, three other plans were successively filed by Federal (R. 118).[5] The plans were filed as declarations under Section 7 of the Act, requiring the Commission's consideration of whether it was "detrimental to the * * * interest of investors" within the meaning of Section 7 (e). The Commission, without objection by respond-

[5] The management's vacillations with respect to plans appear to have been due in part to problems assumed to exist under Delaware law (R. 3; Tr. 10–11, 493–497, 789, 3226–3246). At one time, doubt was expressed whether, under Delaware law, it would be possible to satisfy the preferred stockholders' claims, including dividend arrears, through issuance of a single class of new common stock, if any participation should be allowed to the holders of the Class A or Class B stocks (R. 3, 19–20). (See *Keller* v. *Wilson & Company*, 190 Atl. 115 (Del. 1936); *Consolidated Film Industries, Inc.* v. *Johnson*, 197 Atl. 489 (Del. 1937); *Havender* v. *Federal United Corporation*, 6 A. (2d) 618 (Del. 1939)). Subsequently, the case of *Havender* v. *Federal United Corporation*, 11 A. (2d) 331 (Del. 1940), indicated that the obstacles to a one-stock recapitalization under Delaware law would not apply if the transaction took the form of a statutory merger. Federal's fourth plan was designed to conform to the procedure suggested by the *Havender* case (R. 19–20). Because of alleged doubts as to the constitutionality of Section 11 (e) of the Act, the company did not seek to avail itself of the reorganization machinery of that Section (R. 43–44; Tr. 1905–1906) whereby the Commission may apply to a federal equity court to enforce a plan without the consents required by state law if the plan is found fair and equitable and necessary to effectuate the provisions of Section 11 (b), and if the company requests such enforcement. When Federal's plans were filed, there existed no judicial precedent for the enforcement of a plan approved

ents, also considered (R. 129, 132) the proposals as embodying plans under Section 11 (e) to eliminate undue complexities as required by Section 11 (b) (2) of the Act. Accordingly, in passing on the proposal, the Commission considered it in the light of standards of both Sections 7 (c) and 11 (e).

Throughout the four years during which its plans were pending the management of Federal, whose interests were originally identified primarily with the Class B stock (R. 14), sought to perpetuate the strategic advantages inherent in the dominant voting power of the Class B stock, although there was no equity for that class (R. 101–102, 118) and very little for the Class A stock (R. 101–102, 118). Their efforts followed three main courses: (1) to consummate a plan of recapitalization which would allot substantial participation to the Class B stock (Tr. 1, 5–6, 13; 459–465; 487, 499–504); (2) to re-elect the incumbent directors for long and "staggered" terms (Tr. 520–522; R. 122); and (3) to acquire pre-

by the Commission under Section 11 (e). The constitutionality of Section 11 (e) was not judicially determined until June 15, 1940, in *In re Community Power & Light Co.*, 33 F. Supp. 901 (S. D. N. Y.). Federal itself reserved the right to challenge the constitutionality of all provisions of the Act except the registration provisions (see *e. g.*, Tr. 26, 516, 794, 1905–1906, 3220–3221). Under the company's self-imposed limitations, the plan could be accomplished only by charter amendments and other devices provided by the laws of Delaware.

ferred stock for the purpose of preserving their own dominant position in the event the Class B stock should ultimately be eliminated (R. 14–15; 23). The last mentioned course, described more fully below (pp. 12–14), is the one in issue here.

In order to accomplish a recapitalization, Federal proposed plans which fell within two general categories. The first category consisted of a plan only to remove, by means of a so-called "accounting reorganization," the existing and potential deficit in order to cure the obstacle against payment of dividends (R. 19; Tr. 459–465, 3150–3160). This type of plan embodied proposed reductions in the stated capital applicable to the various classes of stock (Tr. 3153), the creation by this means of a new capital surplus (Tr. 3164), and the use of the capital surplus so created to absorb the deficits (Tr. 3164). This method left untouched existing voting rights, liquidation rights, and dividend accumulations (Tr. 3166), and did nothing to remove the complexity of the capital structure or the top-heavy burden of current dividend requirements (R. 18–19). It left the worthless Class B stock with substantially unimpaired position (Tr. 464), and did not advance the objective of bringing the complex capital structure and unfair distribution of voting power into compliance with Section 11 (b) (2) of the Act (R. 117–118).

The other category of plan advanced by Federal, involving the submission of three separate proposals (Tr. 1–15; 487–523; 782–800), provided for a recapitalization which would remove dividend accumulations and create new stock in place of the outstanding preferred and Class A stocks (Tr. 6, 496–504, 786–788). This type, in its earlier forms, retained for the worthless Class B stock an interest in the company either through option warrants or through "special stock" having voting power and exchange features similar to option warrants (Tr. 12–16, 499, 502–504). In addition, the third and fourth plans proposed to insure the continued control of the system by Federal's management through the device of electing the existing directorate for "staggered" terms (Tr. 521–523, 798–799; R. 21).

At various times, all of these plans were the subject of discussions with the Commission's staff and of formal administrative hearings (Tr. 1356–3043, 3437–3499; R. 3). On May 19, 1938, while the first plan was pending, the second plan was formally filed for consideration in the event the Commission should not approve the first plan (Tr. 3151–3152). On May 11, 1939, a third plan was presented (Tr. 487–523). On August 26, 1939, the first and third plans were withdrawn, leaving only the second—a capital reduction type of plan—before the Commission (Tr. 753). The

fourth and final plan was not filed until March 30, 1940 (Tr. 782–800).*

This plan proposed the merger of Federal, Utility Operators Company (see *infra*, p. 12) and Federal Water and Gas Corporation into Federal, the surviving corporation, which was to change its name to that of its subsidiary, Federal Water and Gas Corporation (R. 20, 119–122).† The preferred and Class A shares of Federal were to be converted into 1,058,268 common shares of the surviving corporation, of which about 95% was to be issued to the preferred stockholders and 5% to the Class A stockholders (R. 119–120). The Class B stock was to receive nothing (R. 120), but a "staggered board" provision was inserted for the express purpose of preserving the existing management for a period (R. 21, 122) as the price of surrender of the Class B stock (Tr. 2505–2507). In the merger,

* By March 30, 1940, there had been no improvement in the financial condition of Federal. The balance sheet on December 31, 1939, stated the total assets at $29,915,729, of which investments comprised $23,836,361, a figure the management itself regarded as excessive. In addition, there were intangible items of nearly $2,000,000, which were to be written off. The earned surplus deficit had increased to $3,865,070 and there was a capital surplus deficit of $3,848,865. Dividend accumulations on the preferred stock had increased to $8,259,042 and on the Class A stock to $9,479,583. (R. 70; Tr. 828–829, 835.)

† Federal Water and Gas Corporation, hereinafter called "Federal Gas," was a wholly owned subsidiary of Federal. It had no important assets, and existed to preserve its corporate name for Federal (R. 64; Tr. 1129).

the outstanding stock of Utility Operators Company (hereinafter called Operators), of which respondents held about one-third (Tr. 581–584), was to be exchanged for approximately 41,500 shares of the new common stock, which represented the value of the Federal preferred stock, debentures and other assets held by Operators (R. 120).

Under this plan respondents would have been permitted to participate in the plan with respect to all preferred stock held by them directly or through Operators on the effective date of the plan (R. 119–121, 124).

Respondents' relation to Federal and their purchases of stock.—All of Federal's Class B stock and about 6,500 shares of preferred stock were owned by Operators (Tr. 14). Operators was also a registered holding company. Its assets consisted of this stock of Federal, a few debentures of Federal, and a small amount of miscellaneous items (R. 115). The individual respondents and C. T. Chenery, who controlled the respondent Chenery Corporation, were officers or directors of Federal or its subsidiaries and were also officers, directors, and principal stockholders of Operators (Tr. 14, 17–19, 1171–1172; R. 86–87). The Class B stock, being a unified voting block, controlled Federal, even though by virtue of dividend defaults the Class A stock had acquired 44.80% of

the voting power and the preferred stock had acquired 12.4% (Tr. 15).[4]

During the period from November 8, 1937, to June 30, 1940, when Federal's several plans were on file or under discussion, and when it was apparent that the Commission's staff would oppose participation of Class B stock, the respondents purchased a total of 12,407 shares of Federal's preferred stock (Tr. 71–72). Most of these shares were purchased on the over-the-counter market at prices which were below the book value of the common stock of the surviving corporation into which they would have been converted (R. 124). The relative importance of the stock held by respondents which was purchased subsequent to November 8, 1937 (R. 57–60), is shown as follows (figures are approximate):

Name	Number of shares of Federal's preferred (150,000 outstanding)	Number of shares of surviving company to be received in exchange	Percentage of shares of surviving company (1,050,000 to be issued)
Preferred stock owned by respondents before 11/8/37:			
Respondents' holdings in other preferred shares owned by Quintuplex			2.7+%
Preferred stock purchased by respondents after 11/8/37			4.1+%
			10.4%

[4] There were about 6,000 preferred stockholders and 10,000 Class A stockholders (Tr. 1557).

The 12,500 share block had been deliberately acquired in the light of views expressed by the Commission's staff concerning the impropriety of participation for the Class B stock and for the avowed purpose of preserving the respondents' interest in and control of Federal even though they might lose the Class B stock (R. 14–15, 23–24). The purchases were reported by respondents pursuant to Section 17 of the Act (R. 17–18). The Commission found that after individual stockholders had complained of respondents' purchases, the officers and directors agreed upon a policy of deferring individual purchases while particular plans were in contemplation but had not been made public (R. 125).[9] The Commission made no finding of fraud or concealment of information (R. 124–125).

The Commission's determinations.—On March 24, 1941, the Commission, after hearings and argument, promulgated its findings and opinion, which "for the present" (R. 130) denied effectiveness to the fourth plan on the ground, so far as here material,[10] that participation of the preferred shares acquired by respondents after November 8, 1937,

[9] The Commission found that "an honest effort appears to have been made to adhere to this policy" (R. 125).

[10] The Commission also disapproved the "staggered board" provision as an attempt to perpetuate the position of the Class B stock which was found to be without equity (R. 130–131). The Commission found further that the par value of the common stock to be issued was fixed at too high a figure. These determinations are not in issue here.

on a basis of equality with the other preferred shares of Federal would make the terms of issuance of the new stock "detrimental to the interests of investors," under Section 7 of the Act, and the plan "unfair and inequitable," under Section 11 (e) (R. 129, 132).[11] The Commission, however, withheld for 30 days entry of an order refusing to permit the declaration to become effective, stating that it would further consider the matter if Federal meanwhile filed amendments to cure the defects in its plan (R. 131).

On July 1, and August 12, 1941, after further informal discussions between the Commission's staff and the management, Federal filed amendments to the plan of merger in response to this suggestion (Tr. 1030, 1046). The amendments included provisions (to which respondents agreed subject to a reservation of any right they might have to review the Commission's action) that (a) no stock in the surviving corporation should be issued for the preferred shares acquired by respondents after November 8, 1937; and (b) respondents would surrender the stock to the surviving corporation at cost plus 4% inter-

[11] A majority of the Commission approved the general framework of the plan, Commissioner Healy dissenting with respect to the participation accorded the Class A stock. That question is not, however, involved in the present proceeding, and the Commission was unanimous in holding that in view of the respondents' participation under the plan disapproval would be required unless corrective amendments were filed (R. 115–132).

est, less all profits made by respondents on any sales thereof (R. 80–85).

Following the filing of these amendments, the Commission permitted the respondents to intervene (R. 96–97). They filed a pleading and briefs requesting the Commission to reconsider the case and to deny effectiveness to the amended plan unless modified to allow the preferred stock in question to participate in the reorganization on a parity with the other preferred stock (R. 85–95, 104–105). On September 24, 1941, the Commission issued a report on the amended plan (R. 97–103), and Supplemental Findings and Opinion adhering to the views expressed in its earlier opinion (R. 108) and approving the amended plan (R. 104–111). By order of the same date, the Commission permitted the declarations embodying the amended plan to become effective forthwith subject to conditions which are not now important (R. 112–113).

On review of the Commission's order, in which respondents raised only the issue now involved (R. 1–10), the Court of Appeals, Justice Miller dissenting, reversed the Commission's order and remanded the cause for further proceedings in accordance with the court's opinion (R. 139–155).

SUMMARY OF ARGUMENT

The issue before the Commission was whether it would be "fair and equitable" and not "detrimen-

tal to the public interest or the interest of investors" to permit respondents, who in the course of the four years during which reorganization had been pending had attempted by varying methods to retain their control of Federal, to participate as to stock acquired by them during the pendency of the reorganization on a parity with all other stock of the same class. The Commission's determination that it would not be fair and equitable and that it would be detrimental to the interests required to be protected is soundly based upon applicable principles relating to fiduciaries and is consistent with the statutory standards.

The respondents, as officers, directors and controlling stockholders, had substantial powers over the reorganization of Federal under the Act. Through the exercise or non-exercise of those powers, respondents could affect extensively the rights and interests of all the stockholders in the corporation. These circumstances warranted the Commission in imposing upon respondents fiduciary obligations to Federal and its stockholders, comparable to those borne by "reorganization managers" and "protective committees" in judicial reorganization proceedings. Applicable principles of equity, therefore, furnished the basis for precluding respondents from acquiring for profit securities of Federal while they were engaged in formulating and proposing plans of reorganiza-

tion. Neither a director's liability to stockholders in the ordinary buying and selling of corporate securities nor the security trading provisions of Section 17(b) of the Act relieved respondents from their fiduciary obligation to all of the stockholders in connection with the plan. On the contrary, the broad standards of Sections 7 and 11, and the legislative history of those sections, plainly establish that Congress intended to vest the Commission with powers in situations like the present at least equal to those powers which inhere in bankruptcy courts and under which such courts have imposed obligations analogous to the obligations here imposed by the Commission.

ARGUMENT

THE COMMISSION PROPERLY LIMITED RESPONDENTS' PARTICIPATION IN RESPECT OF SECURITIES PURCHASED BY THEM IN THE COURSE OF THE REORGANIZATION

Between 1937 and 1940, in recognition of the need for Federal's reorganization, Federal, Operators, and their subsidiary, Federal Water and Gas Corporation, filed applications and declarations with the Securities and Exchange Commission which in their ultimate form were designed to effect a readjustment of the rights of Federal's stockholders by merger of Federal with the other two corporations. In all, four separate plans, several times amended, were advanced.

In these proposals, respondents played the major role. Directors, officers and principal stockholders of Operators, respondents were also offi-

cers or directors of Federal or its subsidiaries. Through Operators' holdings of Class B stock, comprising a unified voting block, respondents controlled Federal. Their discussions with the Commission's staff and hearings before the Commission's trial examiners made it apparent to respondents that a major obstacle to the Commission's approval of the declarations and plans lay in the provisions for participation of the Class B stock controlled by respondents. Nevertheless, throughout the four year period, respondents placed before the Commission plans which, in varying forms and by varying methods, proposed to perpetuate respondents' control over Federal by assuring survival of that control after readjustment.

Initially, respondents' plans to achieve this objective took the form of proposed recapitalizations which would permit significant participation to the Class B stock, and of proposed reelection of the incumbent directors for long and staggered terms (*supra*, p. 10). Meanwhile, respondents acquired preferred stock for the express and admitted purpose of insuring their personal interests and their enduring control in the event of the ultimate elimination of the Class B stock.[12] Finally, in 1940, after respondents had purchased substantial amounts of the preferred stock, Federal filed its fourth plan, by which

[12] C. T. Chenery, president of Federal, testified (R. 14–15): As long as we thought that a plan would be worked

for the first time the Class B stock was to receive nothing, but the preferred and Class A stock of Federal were to be converted into common shares of the corporation surviving the proposed merger. Under this proposal, respondents through their direct and indirect holdings of Federal's preferred stock would have owned somewhat more than 10 per cent of the shares of the surviving company.[15]

It was in these circumstances that the Commission was faced with the issue whether to approve respondents' fourth and final plan which thus

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out which would give the B Stock an opportunity to come back in the future, my suggestion was to those stockholders and I think I testified to this effect at the first hearing here in 1937 that they should save so that at the expiration or at the end of the period, they would be in a position to exercise the option and acquire that stock. Then when it became apparent that this was not to be, a meeting was held of the B stockholders and it was their decision that they would contest any plan which worked them out completely and the suggestion was made that it would be wise to purchase such preferred stock as they reasonably could so that in the event that there was litigation and the plan was not worked out and that finally it should be held that the B stock was not entitled to anything, that these men who had held this Corporation together and who were its loyal servants would still have some position in the Corporation, some voice.

[15] The significance of the proposed holdings of respondents in the surviving corporation is underscored by Section 2 (a) (7) (A) of the Act, in which Congress has defined a holding company to include a company which owns or con-

would have permitted perpetuation of respondents' control. In resolving this issue, the Commission was required [14] by paragraphs (d) (6) and (e) of Section 7 of the Act (Appendix, *infra*, p. 50) to determine whether the proposed alteration of the rights of Federal's security holders would be "detrimental to the public interest or the interest of investors or consumers". In addition, although the declarations had been filed under Section 7, Federal plainly and admittedly was in need of reorganization or recapitalization in the light of its complex structure, its financial condition, and its inequitable distribution of voting power (*supra*, pp. 4–7). Federal's declara-

trols 10 per cent or more of the voting stock of another company. Congress has thus recognized the potential power of a closely held 10 per cent of voting stock. And it should be noted that the remaining voting power would have been widely scattered among some 16,080 preferred and Class A stockholders of Federal (Tr. 1597).

The fourth plan also proposed the continuation in office of the incumbent directors (R. 122).

[14] Section 6 (a) (Appendix, *infra*, p. 49) prohibits registered holding companies from issuing or selling securities and from altering the rights of outstanding securities, except, in so far as here material, in accordance with effective declarations filed with the Commission by such companies under Section 7. Paragraph (f) of Section 7 empowers the Commission to attach to its order permitting declarations to become effective such terms and conditions as it finds necessary to assure compliance with the standards specified in Section 7.

The technical issue before the Commission was whether to permit the declaration to become effective.

tions embodying the various plans looked toward reorganization and capitalization to meet the requirements of Section 11. And accordingly, it was necessary for the Commission to test the plan not only by the standards of Section 7, but also by the standards, embodied in Section 11 (e) (Appendix, *infra*, pp. 52–53) that the plan be "necessary to effectuate the provisions of subsection (b)"[15] and be "fair and equitable" to the persons affected."[16]

The issue before the Commission, acting as an administrative agency under these broad stand-

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[15] Section 11 (b) (2) of the Act (Appendix, *infra*, pp. 51–52) requires the Commission to order registered holding companies and their subsidiaries to take such steps as the Commission finds necessary to insure that the structure of holding companies does not unduly or unnecessarily complicate the structure of the holding company system or that voting power is not unfairly or inequitably distributed among security holders. Subsection (e) (Appendix, *infra*, pp. 52–53) permits any registered holding company or subsidiary to submit a plan to the Commission for the purpose of enabling such company to comply with the provisions of subsection (b).

[16] Respondents did not question, either before the Commission or before the court below, the Commission's holding (R. 122–123, 131–132) that the standards of Section 11 were applicable to the proceedings. On the contrary, in their petition for review in the court below, respondents affirmatively urged that the Commission's order was "unfair and inequitable" (R. 8). Similarly, before the Commission respondents contended that approval of the fourth plan as amended in accordance with the opinion of March 24, 1941 (*supra*, pp. 14–15), would be "unfair" and "inequitable" (R. 93).

ards of the Act was, therefore, whether a plan, which permitted the securities acquired by respondents during the four years' pendency of the reorganization which they had initiated, was "detrimental to the public interest or the interest of investors or consumers", and, by comparable standards, not "fair and equitable."[11] In exercising its duty to resolve this issue under the standards of the Act, the Commission necessarily turned to such relevant analogies as the rules enunciated by Congress and by the courts dealing with the contents of the clause "fair and equitable" in related fields (R. 125–132). In the light of all available experience and authority, the Commission concluded that, notwithstanding the normal right of management freely to deal in securities and to enjoy the full fruits of such dealing, it would be inconsistent with the standards of the Act to permit securities acquired by management pending and in contemplation of this reorganization to participate in the reorganization

[11] Technically, the question before the Commission was the converse: After the plan had been amended to conform to the Commission's opinion of March 24, 1941, the issue was whether the declaration thus *eliminating* respondents' newly acquired holdings from participation (subject to a right to surrender them for cost plus 4 per cent interest) should become effective as not detrimental to the public interest and the interest of investors and whether the plan, embodying such elimination, was fair and equitable. But the issue in the proceeding for review has been more realistically treated as stated in the text.

on an equal basis with other securities not so acquired.

A majority of the court below posed the issue as turning upon the question "whether there is any statute, regulation, or rule of common law or equity which proscribes" the respondents' security transactions during reorganization (R. 143). Since the majority found no such statute, regulation, or rule, it concluded that the Commission's findings and determination were unauthorized by the Act, that the Commission had made a policy determination open only to Congress, and that the order was therefore invalid (R. 139–150). We submit that the court below was in error in thus posing the issue. The issue was, rather, whether the Commission could properly conclude that it would be "detrimental to the public interest or the interest of investors" and that it would be unfair and inequitable to permit the securities acquired by respondents while reorganization was pending to participate equally with others in the reorganization. We urge that the Commission's resolution of this question is in accord with current legislative and judicial concepts of management's obligations in analogous fields and is, under the same analogies fixing the elements of what is "fair and equitable," wholly consistent with the statutory standards which the Commission was required to apply. If this be so, as we submit it is, the Commission was free to adopt the princi-

ple, and since its determination was reasonable, it should not have been overturned by the court below. *United States* v. *Lowden*, 308 U. S. 225, 231, and cases cited; *Gray* v. *Powell*, 314 U. S. 402.[18]

Respondents' fiduciary position and obligations.—The Commission, in applying the statutory standards to the declarations and plans before it, adopted guides from analogous fields where fiduciary relationships are found to exist and fiduciary obligations are imposed. It concluded that, in the circumstances presented by the case, respondents' position and powers in the reorganization were such as to require their treatment as fiduciaries;[19] it concluded also that, since respond-

[18] See also *Federal Trade Commission* v. *Keppel & Bro., Inc.*, 291 U. S. 304, 314; *Federal Radio Commission* v. *Nelson Brothers Bond & Mortgage Co.*, 289 U. S. 266; *United States ex rel. Ness* v. *Fisher*, 223 U. S. 683; Note (1942) 56 Harv. L. Rev. 126, 130.

[19] Chenery Corporation stands in the same position as the individual respondents. It is a family holding company, controlled by C. T. Chenery, the president of Federal and of Operators (R. 13), and the Federal securities purchased by it were acquired under his direction (R. 13, 23, 24). Applicable to its participation is the rule that "one who knowingly joins a fiduciary in an enterprise where the personal interest of the latter is or may be antagonistic to his trust becomes jointly and severally liable with him for the profits of the enterprise." *Irving Trust Co.* v. *Deutsch*, 73 F. (2d) 121, 125 (C. C. A. 2), certiorari denied *sub nom. Bell* v. *Irving Trust Co.*, 294 U. S. 709; *Jackson* v. *Smith*, 254 U. S. 586. The Commission treated Chenery Corporation as in the same position as the other respondents, and no error has been assigned in respect of this treatment.

ents should be treated as fiduciaries, the principles developed and established by Congress and the courts restricting fiduciaries who hold positions and powers similar to those of respondents should be imported into the instant situation. (R. 107–108, 124–129, 132.) Accordingly, it permitted the declarations to become effective only after the plans eliminated opportunity for profit from participation of stock acquired by respondents in the course of reorganization.

The propriety of the Commission's treatment of respondents, managers of Federal, as fiduciaries, is apparent from analysis of the powers vested in them by the Act in respect of reorganization proceedings. By the relevant provisions of the Act Congress vested in the management of a holding company sweeping powers to represent all the stockholders in formulating, initiating and effecting a plan of reorganization.

Primarily, it should be noted that management has significant powers in initiating and timing action looking toward reorganization under the Act. Only the Commission (Section 11 (b) (2), Appendix, *infra*, pp. 51–52) and the holding company itself (Section 11 (e), Appendix, *infra*, pp. 52–53) may initiate action under the Act for the purpose of simplification of corporate structures and of fair and equitable distribution of voting power among security holders. No provision is made in Section 11 (b) or (e) for the

institution of proceedings other than by the Commission or the company itself.[20]

The powers of management to initiate and time reorganizations were particularly significant during the period here in question; over a substantial portion of the period, these powers rested in the hands of management to the exclusion even of the Commission. Section 11 (b) permitted the Commission to proceed on its own motion only after January 1, 1938, while under Section 11 (e) the machinery for accomplishing reorganization and other action to comply with Section 11 (b) was available to the managements of registered holding companies at any time after January 1, 1936. Management thus enjoyed the sole power for two years. And, as a practical matter, this two-year period was substantially extended.[21] The Commission's publicly

[20] See *Republic Service Corp.*, Holding Company Act Release No. 3513 (May 9, 1942), in which the Commission held that an individual preferred stockholder could not file a plan of reorganization under Section 11 (e). In cases where a proceeding is instituted by the Commission under Section 11 (b) and application is made to a court under Section 11 (d) to enforce the Commission's order, the plan may be proposed by the Commission or by any person having a *bona fide* interest in the reorganization.

[21] It was not until after the decision of this Court in *Electric Bond & Share Co.* v. *Securities and Exchange Commission*, 303 U. S. 419 (decided March 28, 1938), that there was general compliance with the registration provisions of the Act. Federal registered on November 8, 1937, the day on which *Electric Bond & Share Co.* v. *Securities and Exchange Commission*, 92 F. (2d) 580 (C. C. A. 2), was decided.

announced policy was to allow an additional period for voluntary compliance before instituting proceedings to enforce compliance with Section 11. The Commission's Annual Report for the fiscal year ended June 30, 1938, transmitted to Congress on January 3, 1939, stated at page 10:

> It will be realized that the problem of conforming the electric and gas utilities to the requirements of Section 11 (b) is a task of great magnitude. Its most expeditious accomplishment turns upon the willingness of the industry voluntarily to take the necessary steps. The Commission's policy has been and is to give each holding company every reasonable opportunity to effectuate the Section 11 (b) programs by voluntary proceedings, and to institute involuntary proceedings under Section 11 (b) only as a last resort or where the exigencies of special situations make such a course desirable or necessary.[22]

[22] In the Commission's Report there appeared the following footnote to the above-quoted statement:

> On May 5, 1938, a Committee of Holding Company Executives was chosen by 14 major utility systems for the purpose of conferring with the Commission from time to time on these and other problems arising under the Public Utility Holding Company Act of 1935. On August 3, 1938, Chairman Douglas addressed a letter to the heads of all registered holding companies requesting the various systems to present, not later than December 1, 1938, tentative suggestions and programs looking toward compliance with Sections 11 (b) (1) and 11 (b) (2) of the Public Utility Holding Company Act of 1935.

In pursuance of this policy, it was not until the spring of 1940 that the Commission instituted enforcement proceedings against the major holding company systems. Until that time, management alone controlled the initiation of proceedings.[23]

Management power also extends to other important elements of the reorganization proceedings. It has control as well over the development of the action. Thus, under Sections 7 and 11 (e) only the management may amend the plan, and it may do so at any time; only the management may withdraw the plan, and this too it may do at any time; and the management may conclude not to carry it out even after Commission approval.

This type of reorganization procedure, therefore, in contrast to the procedure prescribed by

[23] It is clear that the Commission was intended by Congress to initiate action only after other possibilities had been exhausted. Thus it was stated in the Report of the National Power Policy Committee, which was annexed to the report of the Senate Committee on Interstate Commerce approving an earlier draft of the Act, that (S. Rep. No. 621, 74th Cong., 1st Sess. (1935), pp. 58, 60):

> Furthermore, it seems administratively advisable that every opportunity be offered the owners of holding-company securities to work out their own processes of dismantling * * *.
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> * * * * * * *
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> * * * Voluntary action by the companies should be encouraged as much as possible, but the commission should be empowered to issue orders compelling necessary divestments, dissolutions, and reorganizations. * * * *

Chapter X of the Bankruptcy Act, places essential power in the hands of management rather than of security holders. If it were not safeguarded by appropriate administrative procedures, the procedure would involve the dangers of a "short receivership" or a "management plan,"[24] rather than a judicially supervised reorganization. In these circumstances management, having so large a measure of control, may reasonably be charged with the duty to represent all classes of security holders and to come forward with and develop a plan fair to all. When management is vested with such significant control, and so solemn a duty of representation, management trading in the securities involved in the reorganization inevitably and at the very least creates problems of divided loyalties. In such reorganizations, it is in the power of management to formulate, present and withdraw plans, to time the submission of plans and the filing of amendments, and to have access, through negotiations with the Commission, to information not available to the security holders regarding the future course and probable result of proceedings. With these powers management can, through dealing in the securities, realize profits and dispose of those securities most likely to be valueless as a result of the reorganization, or—as occurred here—acquire for its own benefit those securities likely to survive and to possess voting control.

[24] See S. E. C. Protective Committee Study, Part VIII, pp. 318–322; Part VII, *passim;* Part I, p. 312 ff.

Thus, the position of the management of a holding company during the pendency of reorganization proceedings under the Act is analogous to the position of a protective committee or of reorganization managers who undertake to initiate and evolve a plan of reorganization. See *infra*, p. 44, note 37. They are fiduciaries because of their power to act in the reorganization proceeding on behalf of the security holders. *In re Republic Gas Corp.*, 35 F. Supp. 300 (S. D. N. Y.); *In re Paramount-Publix Corp.*, 12 F. Supp. 823, 828 (S. D. N. Y.), affirmed, 83 F. (2d) 1015 (C. C. A. 2); see *American Ins. Co.* v. *Avon Park*, 311 U. S. 138, 147. And, indeed, the power of officers and directors over a "voluntary reorganization" like the one here involved is even broader than that of a protective committee in a typical judicial reorganization. A protective committee's control of a judicial reorganization under the Bankruptcy Act is limited by the fact that individual security holders have the right to initiate such proceedings. Management or protective committee control in such reorganization is further curtailed by the typical emergence of new leaders, such as indenture trustees or court-appointed trustees. Here, in contrast (as has been noted *supra*, pp. 26–29), the management controlled the proceeding, subject only to the power of the Commission to disapprove the plan, to impose conditions upon approval, or to propose a plan at a later time as a means of en-

forcing an order entered in a proceeding instituted by it under Section 11 (b) of the Act.[28] The strategic position enjoyed by the management in this type of reorganization proceeding and the vesting in it of statutory powers available to no other representative of security holders plainly warrant the Commission's treating respondents as fiduciaries obliged to observe at least the higher standard of conduct required of members of protective committees. *Cf. Woods* v. *City Bank Co.*, 312 U. S. 262, 268.[29]

Admittedly, as held below (R. 143–144), directors and officers, by the weight of authority, are not fiduciaries for the individual stockholders in their day-to-day purchases and sales of corporate stock. But that rule has no relevance here, for in such a

[28] The Commission's current practice is to institute cross-proceedings under Section 11 (b) and to consolidate hearings on the cross-proceedings with the hearing on a plan under Section 11 (e). However, even under this practice, which had not been developed at the time of the instant proceedings, the management enjoys considerable strategic advantage with reference to the timing of reorganization.

[29] A majority of the court below, however, held (R. 147) that the principles relating to protective committees could not be applied here by the Commission since respondents, in contrast to protective committees, did not act under a deposit agreement or other written instrument, or an express trust. But the fiduciary obligations of members of protective committees to the security holders they undertake to represent are not dependent upon the existence of an express trust or upon the deposit of securities with the members. *United States* v. *Buckner*, 108 F. (2d) 921, 926–927 (C. C. A. 2), certiorari denied, 309 U. S. 669; see Note (1936) 46 Yale L. J. 143, 145.

case as this the effect of trading by management is not measured by the fairness of individual transactions between buyer and seller, but by its relation to the timing and dynamics of the reorganization which the management itself initiates and so largely controls.

The court below also held (R. 148) that the Commission's treatment of respondents as fiduciaries was erroneous since even after Commission approval of the plan, its consummation would still be subject to a vote of stockholders and to conformance with state law. Participation by others plainly cannot free respondents from responsibility for their activities. The mere fact that some other body or group will pass on the plan cannot justify disregard of fiduciary responsibilities; if it could, there would be no basis for judicial and legislative restrictions upon security trading by reorganization managers and protective committees in judicial reorganization proceedings. Moreover, the reasoning of the court below completely overlooks the prejudice to security if antagonistic trading interests of the management should lead it to delay the presentation of an adequate plan."

" Thus it has been held that corporate managers, under certain circumstances, owe a duty to stockholders to institute proceedings for the dissolution of the corporation and are accountable to the stockholders and the corporation as fiduciaries for personal gains and emoluments during the period in which they have delayed and refused to institute such pro-

The facts relating to respondents' power and position in connection with the reorganization proceedings were, therefore, at least as compelling as the facts which underlie judicial treatment of those with similar power and position as fiduciaries in comparable situations." Accordingly, the remaining question before the Commission was what obligations flow from respondents' fiduciary relationship. The Commission, as we have noted (*supra*, pp. 25–26), looked to legislative and judicial analogies in related fields for guides in determining the content of the standards of fairness and equity, and of action in the public interest and in the interest of investors. These analogies, applicable because of respondents' positions as fiduciaries, warranted the Commission in finding that participation of holdings acquired by respondents

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ceedings. *Kroger* v. *Jaburg*, 231 App. Div. 641, 248 N. Y. S. 387 (1st Dept. 1931); *Miner* v. *Belle Isle Ice Co.*, 93 Mich. 97, 53 N. W. 218 (1892). Cf. *Tower Hill-Connellsville Coke Co.* v. *Piedmont Coal Co.*, 64 F. (2d) 817 (C. C. A. 4), certiorari denied, 290 U. S. 675.

[11] The Commission's action here was far less drastic than that prescribed by this Court in *Taylor* v. *Standard Gas & Electric Company*, 306 U. S. 307, in which this Court held that a debt claim of a controlling stockholder which had organized a corporation with a top-heavy and insufficient capitalization, and which had been guilty of other mismanagement, should be subordinated to publicly held preferred stock. In this case the respondents although not found to be responsible for creating the financial difficulties confronting the company were in control at a time when the company was in need of reorganization to cure a capital structure which had proved to be top-heavy. Before going forward

during reorganization did not satisfy the standards of Sections 7 and 11 of the Act.

It has long been settled that, in order to minimize dangers of divided loyalties implicit in such transactions, a trustee is prohibited under equity principles from purchasing property embraced by the trust "though he has done so for a fair price, without fraud, at a public sale." *Michoud* v. *Girod*, 4 How. 502, 557 (1846); *Magruder* v. *Drury*, 235 U. S. 106; *Meinhard* v. *Salmon*, 249 N. Y. 458. Cf. *Woods* v. *City Bank Co.*, 312 U. S. 262, 268. And this rule, for reasons which apply equally to the instant situation (*supra*, pp. 25–32), has been extended to members of protective committees.[29] *In re Republic Gas Corp.*, 35 F. Supp. 300 (S. D. N. Y.); *In re Paramount-Publix Corp.*, 12 F. Supp. 823 (S. D. N. Y.), affirmed 83 F. (2d) 1015 (C. C. A. 2). Under these de-

realistically with the job, as their controlling position obligated them to do, they shifted their position into securities which would survive the reorganization. While, therefore, the situation is not identical to that in the *Standard Gas* case, we submit that analogous equitable principles warrant attaching to the less serious breach of fiduciary obligations here involved the far less drastic consequences imposed by the Commission, namely, limitation of the management of Federal to cost plus 4 per cent.

[29] Comparable fiduciary obligations have been imposed by equity courts in analogous situations. Thus it has been held that corporate officers or directors may not buy up claims against a corporation in bankruptcy or undergoing reorganization and subsequently enforce them at their fair value. *In re Norcor Manufacturing Co.*, 109 F. (2d) 407 (C. C. A. 7); *In re McCrory Stores Corp.*, 12 F. Supp. 267 (S. D. N. Y.).

cisions members of protective committees who dealt in securities of the corporation pending reorganization have been precluded from receiving compensation for their services, because of their violation of fiduciary obligations. And the rule of these decisions has since expressly been adopted by Congress in Section 249 of the Bankruptcy Act (11 U. S. C., § 649),[20] while in Section 212 of that Act (11 U. S. C. § 612) Congress has authorized the courts to limit claims or stock purchased by a committee during the reorganization to the actual consideration paid—a principle which, it is to be noted, is more restrictive than that adopted by the Commission.

Similarly, under the requirement of Chapter IX (Section 83 (e) (1), 11 U. S. C., § 403 (e) (1)) of the Bankruptcy Act that compositions be "fair" and "equitable",[21] a standard analogous to that

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[20] See *Otis & Co.* v. *Insurance Bldg. Corp.*, 110 F. (2d) 353 (C. C. A. 1); *In re Mountain States Power Co.*, 118 F. (2d) 609 (C. C. A. 3).

[21] Section 83 (e) (1) provides that a plan may not be judicially confirmed unless it is "fair, equitable * * * and does not discriminate unfairly in favor of any creditor or class of creditors * * *." The words after "fair and equitable" are superfluous, for Congress has expressly recognized that, in any event, implicit in the clause "fair and equitable" is a "prohibition against any unfair discrimination in the plan in favor of any class of creditors or stockholders." Senate Judiciary Committee Report on the Revision of the National Bankruptcy Act, S. Rep. No. 1916, 75th Cong., 3rd Sess., pp. 35-36. Accordingly, Congress, when it enacted Chapter X (Section 221 (2), 11 U. S. C., § 621 (2)), did not repeat the latter expression which had appeared in Sections 77B (f) (1) and 83 (e) (1).

which the Commission was required to apply, this Court held that, to the extent that a fiduciary would profit in the plan by means of securities which he had acquired while performing his duties, "the plan would discriminate unfairly in [his] favor." *American Ins. Co.* v. *Avon Park*, 311 U. S. 138, 144.

Like the Commission's choice of remedy, its determination to apply the remedy irrespective of the absence of fraud or malfeasance in the particular case is also in accord with established principles. For as this Court has said in *Woods* v. *City Bank Co.*, 312 U. S. 262, 268, 269:

> • • • It is no answer to say that fraud or unfairness were not shown to have resulted. *Cf. Jackson* v. *Smith*, 254 U. S. 586, 589. The principle enunciated by Chief Justice Taft in a case involving a contract to split fees in violation of the bankruptcy rules, is apposite here: "What is struck at in the refusal to enforce contracts of this kind is not only actual evil results but their tendency to evil in other cases." *Weil* v. *Neary*, 278 U. S. 160, 173 • • •
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> • • • A fiduciary who represents security holders in a reorganization may not perfect his claim to compensation by insisting that, although he had conflicting interests, he served his several masters equally well or that his primary loyalty was not weakened by the pull of his secondary one. Only strict adherence to these equitable principles can keep the standard of conduct

> for fiduciaries "at a level higher than that trodden by the crowd." See Mr. Justice Cardozo in *Meinhard* v. *Salmon*, 249 N. Y. 458, 464; * * *

Cf. *Pepper* v. *Litton*, 308 U. S. 295, 310-311."[32] The rule may in part be, as the court below observed, a "rule of convenience" (R. 148); but it is based upon well recognized factors. It is normally impossible to ascertain whether insiders have in fact taken advantage of the information specially available to them, and whether such information motivated or influenced their transactions. See the concurring opinion of Judge Learned Hand in *Morgan Stanley & Co.* v. *Secu-*

[32] It has been held in a variety of situations that absence of injury to corporations and good faith on the part of the fiduciary furnish no grounds for relieving fiduciaries of their legal duties. Thus, contracts between officers and their corporations are denied enforcement irrespective of damage to the corporation (*Wardell* v. *Railroad Co.*, 103 U. S. 651; *Lum* v. *McEwen*, 56 Minn. 278, 57 N. W. 662 (1894)); a trustee is forbidden to purchase the trust estate at a public sale, even if the trust estate is benefited by the purchase (*Magruder* v. *Drury*, 235 U. S. 106; *Ashman* v. *Miller*, 101 F. (2d) 85 (C. C. A. 6)); officers of a corporation in bankruptcy who purchase its claims at a discount and sell them at their face value must disgorge their profits, even if their activities were of service to the corporation and the corporation was itself unable to handle the claims (*In re Norcor Manufacturing Co.*, 109 F. (2d) 407 (C. C. A. 7); *In re McCrory Stores Corp.*, 12 F. Supp. 267 (S. D. N. Y.)); and officers of a corporation who seize a corporate opportunity for personal benefit may be called to account, even without a showing that the corporation was able to take the opportunity. *Irving Trust Co.* v. *Deutsch*, 73 F. (2d) 121 (C. C. A. 2), certiorari denied *sub nom. Bell* v. *Irving Trust Co.*, 294 U. S. 709.

rities and Exchange Commission, 126 F. (2d) 325, 332 (C. C. A. 2). And respondents' disclosure of their purchases was no safeguard against the abuse here involved; the possibility of advantages to management in its trading, by virtue of its power to time purchases, disclosures, and presentations of plans, is of such permeating importance that, if the investors are to be protected, the management in a situation such as this must be prohibited altogether from profiting from trading in the securities involved in the reorganization which the management formulates and controls.[33] See Note (1936) 46 Yale L. J. 143, 148.

We submit that the Commission's conclusion that the principles relating to the powers and duties of reorganization managers were applicable in the situation before it was peculiarly within the Commission's special administrative competence. The Commission has dealt extensively with corporate reorganizations, both under the Act, and under other statutes entrusted to it. It has, in addition, exhaustively studied protective and reorganization committees. See *Report on the Study and*

[33] There is no force in respondents' suggestion in their brief in opposition (p. 9) that the principle adopted by the Commission is inconsistent with the desirable end of management's holding of stock in corporations entrusted to it. The Commission's determination covers only management's personal acquisition of additional holdings during the pendency of reorganization. No cited principles or authorities *encourage* management to deal in their corporations' securities pending reorganization; and on the other hand nothing in the Commission's holding prevents respondents from purchasing the stock of the reorganized company *after* reorganization.

Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees (1936–1940). Particularly in these circumstances, the court below should not have rejected the Commission's application of reorganization principles.

The effect of Section 17 (b).—Nevertheless, the majority of the court below held (R. 144–145, 149–150) that whatever the desirability of the rule adopted by the Commission, the full measure of the Commission's power to restrict security transactions by directors and officers is marked by Section 17 (a) and (b) of the Act (Appendix, *infra*, pp. 53–54), which requires directors and officers to report their security holdings and which provides that profits realized by them from purchases and sales or sales and purchases of securities of the holding company within any period of less than six months shall inure to the benefit of the holding company. Accordingly, the court was of the view that the Commission was limited by the Act itself from imposing additional restrictions upon the common law right of directors and officers to purchase securities of the company.

We submit that Section 17 (b) does not mark the entire limits of fiduciary responsibility of officers and directors. Section 17 (b), which is the counterpart of Section 16 (b) of the Securities Exchange Act of 1934, deals primarily with transactions in normal situations; it was intended

simply to provide an "arbitrary rule of thumb" essentially designed to discourage short-term trading by insiders; the circumstances of the transaction are, with a single exception,[34] of no concern under the section. See Yourd, *Trading in Securities by Directors, Officers and Stockholders; Section 16 of the Securities Exchange Act* (1939), 38 Mich. L. Rev. 133, 148, 153. Here the Commission was dealing with a special situation, arising not from transactions in the ordinary course of corporate life, but from the dynamics of reorganization.[35] In times of reorganization, officers and directors assume additional functions which go beyond the day-to-day situation contemplated by Section 17 (b) and subject them to the broad standards of Sections 7 and 11.[36]

In *American Ins. Co.* v. *Avon Park*, 311 U. S. 138, 146, the Court stated that where investigation

[34] The restriction of Section 17 (b) does not apply where the "security was acquired in good faith in connection with a debt previously contracted * * *." Appendix, *infra*, p. 54.

[35] Thus it has been suggested that Section 16 (b), an extension of common law principles, could hardly have been intended by Congress to have limited the common law restriction upon fraudulent inside transactions, even beyond the six months' limitation. Yourd, *op. cit. supra*, pp. 147–148.

[36] In a similar situation, this Court applied the general principle forbidding fiduciaries to represent conflicting interests, although other equitable principles applicable to fiduciaries were codified in Sections 249 and 212, and in former Section 77B (h). *Woods* v. *City Bank Co.*, 312 U. S. 262. These codified principles, thus, were not treated as excluding uncodified principles.

shows a "breach of fiduciary obligations, profiting from a trust, special benefits for the reorganizers, or the need for protection of investors against an inside few," a bankruptcy court had ample power to adjust the remedy to meet the need. It may, this Court said, limit the vote to the amount paid for the securities; it may separately classify claimants; it may completely subordinate some of the claims. The power

> is ample for the exigencies of the varying situations. It is not dependent on express statutory provisions. It inheres in the jurisdiction of a court of bankruptcy. The necessity for its exercise * * * is based on the responsibility of the court before entering an order of confirmation to be satisfied that the plan in its practical incidence embodies a fair and equitable bargain openly arrived at and devoid of overreaching, however subtle. * * *

Nothing either in the terms or the legislative history of the Act indicates that the standards of fairness and equity embodied in the Act were intended to have narrower meaning than they have in bankruptcy proceedings in the courts, or that the Commission has less power in applying these standards than that which "inheres in the jurisdiction of a court of bankrputcy" and which is "not dependent on express statutory provisions." On the contrary, the very breadth of the terms of Sections 7 and 11, as well as their history, estab-

lishes that the Commission was intended to be vested with authority to deal as it did here with situations like the present. Thus, Congress stated (S. Rep. 621, 74th Cong., 1st sess. (1935) p. 28) that the provisions of Section 7—

> are designed to give to the Commission continuous supervision over the revamping of holding-company systems to meet the requirements of title I looking toward the establishment of financially sound and economically integrated units and the avoidance of injury to investors * * * *

and that the terms and conditions which the Commission is authorized to impose under Section (f)—

> are designed to give adequate protection to investors and consumers * * * and are in accord with the underlying purpose of the legislation to give to investors and consumers full protection against the deleterious practices which have characterized certain holding-company finance in the past. * * *

So too, it is plain that Congress intended to permit the broadest scope to the Commission in applying the standards embodied in Section 11 in order to effectuate the purpose of the Act in the very situation comparable to that involved here; it was stated (S. Rep. 621, 74th Cong., 1st sess. (1935), p. 33):

> Under these subsections [11 (d), (e), and (f)] Commission approval of reorganiza-

> tion plans and supervision of the conditions under which such plans are prepared will make it impossible for a group of favored insiders to continue their domination over inarticulate and helpless minorities, or even as is often the case, majorities.[37] * * *

Thus, plainly, Congress broadly committed to the Commission the determination whether changes in the rights of security holders such as those proposed by the respondents would be detrimental to the interests of investors, and whether respondents' proposal to redistribute voting power in such a manner as to treat their newly acquired securities on a parity with others would be fair and equitable. The legislative history of Sections 7 and 11 wholly negates any thought that the Congress by Section 17 intended to limit the Commission's power, in proceedings under Sections 7 and 11, to apply appropriate equitable sanctions to the abuse of fiduciary duties, or that it was intended to vest the

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[37] Compare the even more explicit statement embodied in the Report of the National Power Policy Committee, which was annexed to the Senate Committee report (S. Rep. 621, 74th Cong., 1st Sess.). In discussing a provision comparable to the present Section 11 (e), and after referring to the complexities of reorganization involved in the dismantling of vast holding company systems, the report stated (p. 58):

> In destroying the abuses of the holding companies, the Government must not leave great groups of helpless investors to the certain abuses of extensive hurried corporate reorganizations. The dominant groups who have ruthlessly plucked the investor in promoting some of these huge holding companies must not be allowed to pluck him again as reorganization managers.

Commission with less discretion over reorganizations within its jurisdiction than that which inheres in bankruptcy courts in respect of reorganizations within their jurisdiction." See Note (1942) 56 Harv. L. Rev. 126, 128.

CONCLUSION

For the foregoing reasons, the judgment of the court below should be reversed.

Respectfully submitted.

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[35] The court below, however, in (R. 149) support of its view that Section 17 (b) was intended to regulate the entire field, referred to the Report of the Securities and Exchange Commission on proposals for amendment to the Securities Act of 1933 and the Securities Exchange Act of 1934, 77th Cong., 1st Sess., House Committee Print (1941),

p. 36 (where it was emphasized that an insider is required to disgorge profits only when the profits are made within six months), and to the testimony of Chairman Purcell (Hearings before Committee on Interstate and Foreign Commerce on H. R. 4344, H. R. 5065, and H. R. 5832, 77th Cong., 1st Sess. (1942), p. 1255), that Congress prohibited only "the most prevalent form of the abuse of inside information—trading designed to take quick profits from short-term market fluctuations." But these statements are irrelevant here; they were directed toward proposals drastically to amend or repeal Section 16 of the Securities Exchange Act of 1934 and were on behalf of retention of that section.

APPENDIX

The pertinent provisions of the Public Utility Holding Company Act of 1935, c. 687, 49 Stat. 803 (15 U. S. C., §§ 79, *et seq.*), are as follows:

SECTION 1. (a) Public-utility holding companies and their subsidiary companies are affected with a national public interest in that, among other things, (1) their securities are widely marketed and distributed by means of the mails and instrumentalities of interstate commerce and are sold to a large number of investors in different States; * * *

(b) Upon the basis of facts disclosed by the reports of the Federal Trade Commission * * * it is hereby declared that the national public interest, the interest of investors in the securities of holding companies and their subsidiary companies and affiliates, and the interest of consumers of electric energy and natural and manufactured gas, are or may be adversely affected—

(1) when such investors cannot obtain the information necessary to appraise the financial position or earning power of the issuers, because of the absence of uniform standard accounts; when such securities are issued without the approval or consent of the States having jurisdiction over subsidiary public-utility companies; when such securities are issued upon the basis of fictitious or unsound asset values hav-

ing no fair relation to the sums invested in or the earning capacity of the properties and upon the basis of paper profits from intercompany transactions, or in anticipation of excessive revenues from subsidiary public-utility companies; when such securities are issued by a subsidiary public-utility company under circumstances which subject such company to the burden of supporting an overcapitalized structure and tend to prevent voluntary rate reductions;

* * * * * *

(5) when in any other respect there is * * * lack of effective public regulation * * *.

(c) When abuses of the character above enumerated become persistent and widespread the holding company becomes an agency which, unless regulated, is injurious to investors, consumers, and the general public; and it is hereby declared to be the policy of this title, in accordance with which policy all the provisions of this title shall be interpreted, to meet the problems and eliminate the evils as enumerated in this section, connected with public-utility holding companies which are engaged in interstate commerce or in activities which directly affect or burden interstate commerce; and for the purpose of effectuating such policy to compel the simplification of public-utility holding-company systems and the elimination therefrom of properties detrimental to the proper functioning of such systems, and to provide as soon as practicable for the elimination of public-utility holding companies except as otherwise expressly provided in this title.

* * * * * *

Section 6 (a):

SEC. 6. (a) Except in accordance with a declaration effective under section 7 and with the order under such section permitting such declaration to become effective, it shall be unlawful for any registered holding company or subsidiary company thereof, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, directly or indirectly (1) to issue or sell any security of such company; or (2) to exercise any privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security of such company.

* * * * *

Section 7:

SEC. 7. (a) A registered holding company or subsidiary company thereof may file a declaration with the Commission, regarding any of the acts enumerated in subsection (a) of section 6, in such form as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers. * * *

* * * * *

(b) A declaration filed under this section shall become effective within such reasonable period of time after the filing thereof as the Commission shall fix by rules and regulations or order, unless the Commission prior to the expiration of such period shall have issued an order to the declarant to show cause why such declaration should become effective. Within a reasonable time after an opportunity for hearing upon an order to show cause under this subsection, unless the declarant shall withdraw its declara-

tion, the Commission shall enter an order either permitting such declaration to become effective as filed or amended, or refusing to permit such declaration to become effective. Amendments to a declaration may be made upon such terms and conditions as the Commission may prescribe.

(c) The Commission shall not permit a declaration regarding the issue or sale of a security to become effective unless it finds that—

* * * * *

(d) If the requirements of subsections (c) and (g) are satisfied, the Commission shall permit a declaration regarding the issue or sale of a security to become effective unless the Commission finds that—

* * * * *

(6) the terms and conditions of the issue or sale of the security are detrimental to the public interest or the interest of investors or consumers.

(e) If the requirements of subsection (g) are satisfied, the Commission shall permit a declaration to become effective regarding the exercise of a privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security unless the Commission finds that such exercise of such privilege or right will result in an unfair or inequitable distribution of voting power among holders of the securities of the declarant or is otherwise detrimental to the public interest or the interest of investors or consumers.

(f) Any order permitting a declaration to become effective may contain such terms and conditions as the Commission finds nec-

essary to assure compliance with the conditions specified in this section.

* * * * *

Section 11 (b) (2):

(b) It shall be the duty of the Commission, as soon as practicable after January 1, 1938:

* * * * *

(2) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such steps as the Commission shall find necessary to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system. In carrying out the provisions of this paragraph the Commission shall require each registered holding company (and any company in the same holding-company system with such holding company) to take such action as the Commission shall find necessary in order that such holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company. Except for the purpose of fairly and equitably distributing voting power among the security holders of such company, nothing in this paragraph shall authorize the Commission to require any change in the corporate structure or existence of any company which is not a holding company,

or of any company whose principal business is that of a public-utility company.

* * * * * *

Section 11 (e):

(e) In accordance with such rules and regulations or order as the Commission may deem necessary or appropriate in the public interest or for the protection of investors or consumers, any registered holding company or any subsidiary company of a registered holding company may, at any time after January 1, 1936, submit a plan to the Commission for the divestment of control, securities, or other assets, or for other action by such company or any subsidiary company thereof for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions of subsection (b). If, after notice and opportunity for hearing, the Commission shall find such plan, as submitted or as modified, necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan; and the Commission, at the request of the company, may apply to a court, in accordance with the provisions of subsection (f) of section 18, to enforce and carry out the terms and provisions of such plan. If, upon any such application, the court, after notice and opportunity for hearing, shall approve such plan as fair and equitable and as appropriate to effectuate the provisions of section 11, the court as a court of equity may, to such extent as it deems necessary for the purpose of carrying out the terms and provisions of such plan, take

exclusive jurisdiction and possession of the company or companies and the assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, and the court may constitute and appoint the Commission as sole trustee, to hold or administer, under the direction of the court and in accordance with the plan theretofore approved by the court and the Commission, the assets so possessed.

* * * * * *

Section 17 (a) and (b):

SEC. 17. (a) Every person who is an officer or director of a registered holding company shall file with the Commission in such form as the Commission shall prescribe (1) at the time of the registration of such holding company, or within ten days after such person becomes an officer or director, a statement of the securities of such registered holding company or any subsidiary company thereof of which he is, directly or indirectly, the beneficial owner, and (2) within ten days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, a statement of such ownership as of the close of such calendar month and of the changes in such ownership that have occurred during such calendar month.

(b) For the purpose of preventing the unfair use of information which may have been obtained by any such officer or director by reason of his relationship to such registered holding company or any subsidiary company thereof, any profit realized by any such officer or director from any purchase and sale, or any sale and purchase, of any security of such registered holding com-

pany or any subsidiary company thereof within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the holding company or subsidiary company in respect of the security of which such profit was realized, irrespective of any intention on the part of such officer or director in entering into such transaction to hold the security purchased or not to repurchase the security sold for a period of more than six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the company entitled thereto or by the owner of any security of such company in the name and in the behalf of such company if such company shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not cover any transaction where such person was not an officer or director at the times of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may, as necessary or appropriate in the public interest or for the protection of investors or consumers, exempt as not comprehended within the purpose of this subsection. Nothing in this subsection shall be construed to give a remedy in the case of any transaction in respect of which a remedy is given under subsection (b) of section 16 of the Securities Exchange Act of 1934.

* * * * *

Section 24 (a):

SEC. 24. (a) Any person or party aggrieved by an order issued by the Commission under this title may obtain a review of such order in the circuit court of appeals of the United States within any circuit wherein such person resides or has his principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or set aside in whole or in part. * * * The findings of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. * * * The judgment and decree of the court affirming, modifying, or setting aside, in whole or in part, any such order of the Commission shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in sections 239 and 240 of the Judicial Code, as amended (U. S. C., title 28, secs. 346 and 347).

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